2007-08
May 28, 2007

Hungary (the Republic of)

Foreign LT: **A-/Stable**, Local LT: **A /Stable** (affirmed on April 4, 2007)

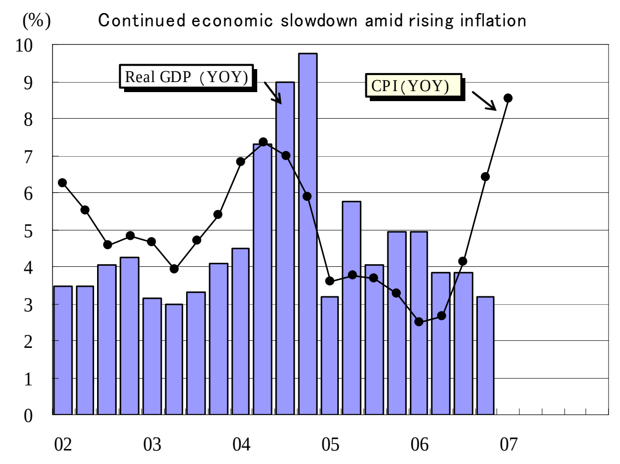
<Rating Perspective>

Positive Factors

- Deepening economic ties with European countries since its early stage of its economic transformation by pushing economic reforms
- Growing exports and enhancing its industrial structure through the expanding country's production capacity following massive FDI inflows

Negative Factors

- Increasing government debt due to persistent large fiscal deficit
- Large foreign debts owed primarily by the private sector



<Updated: from February 2007 to April 2007>

Positive Factors

- The general government fiscal deficit (ESA95) in 2006 ended 9.2% of GDP, lower than 10.1％ under the revised budget plan
- The general government fiscal deficit (GFS, excluding local government) in the first four months of 2007 was 2.9% of GDP, slightly lower than the projection made by the government
- IMF appraised overall progress on the fiscal consolidation plan on May 7
- Current account deficit in 2006 was improved to 5.7% of GDP from 6.8% in 2005

Negative Factors

- Led by continued sluggish domestic demand, real GDP growth rate in the October-December quarter of 2006 went on decelerating to 3.2% year-on-year from 3.8% in the previous quarter
- Consumer price inflation in the first four months of 2007 accelerated considerably to 8.6% year-on-year from 4% in 2006 on increased tax rates and administrated prices
- The central bank revised its inflation projection for 2007 upwardly to 7.4% from 6.9%

<Outlook and Points to Watch>

A crucial stage of fiscal consolidation

(1) JCR has affirmed the ratings on the foreign and local currency in its annual review

On April 4, 2007, JCR has affirmed the ratings on foreign (A-/Stable) and local (A/Stable) currency long-term senior debts of the Republic of Hungary. The affirmation was based mainly on the fact that any further expansion looks likely to be avoided through gradual implementation of the government's deficit reduction package. JCR hold a view that the government may make some headway in implementing the package under the strict surveillance of the European Commission (EC). The government has been required to report progress to the EC twice a year after April 2007. However, its task may not be easy in the face of a prospective economic slowdown and weak public support to the Prime Minister. The government has put off specifying a target date of the euro adoption. The timing of adopting the euro is highly dependent on implementation of the package.

(2) Any further deterioration may be avoided through implementation of the deficit reduction package

The general government fiscal deficit (ESA95) in 2006 ended 9.2% of GDP, lower than 10.1％ under the revised budget plan. Any further expansion of the deficit looks likely to be avoided through gradual implementation of the deficit reduction package. Both expenditures and revenues were in line with those set in the revised budget, an indication of some results produced by the deficit reduction package. Under the package, the government plans to slash the fiscal deficit (ESA95 excluding costs of pension reform unless otherwise indicated) to 6.8% in 2007 and 2.7% in

Jiji Press Building, Ginza 5-15-8, Chuo-ku, Tokyo, 104-0061, JAPAN Tel: 813-3544-7024 Fax: 813-3544-7028 http://www.jcr.co.jp

2010 through expenditure and revenue reforms. The general government fiscal deficit (GFS, excluding local government) in the first four months of 2007 was 2.9% of GDP, slightly lower than the projection made by the government. Moreover, reflecting recent fiscal development, the government revised the fiscal deficit for 2007 from 6.8% of GDP to 6.6%. The deficit reduction package taken so far have been mainly aimed at increasing revenues through higher VAT and corporate tax rates and increased employee contributions to social security. On the other hand, while there has been phased redundancy of public employees, most of the expenditure reforms, in particular those involving the healthcare and pension systems, are set to be implemented in 2007 and 2008.

The assessment on the report submitted to the EC regarding the progress on the deficit reduction package is expected to be made public in June. The assessment looks likely to appraise overall progress on one hand, and it will seek the Hungarian government to push ahead through expenditure reforms and an strict execution of the 2007 budget on the other hand.

(3) Inflation rising amid economy deceleration

Led by continued sluggish domestic demand, real GDP growth rate in the October-December quarter of 2006 went on decelerating to 3.2% year-on-year from 3.8% in the previous quarter. While domestic demand centering on consumer spending and investment continued to weaken due to the gradual implementation of the deficit reduction package, strong exports bolstered the whole economy amid an expansion of the European economy. Consumer price inflation in the first four months of 2007 accelerated considerably to 8.6% year-on-year from 4% in 2006 on increased tax rates and administrated prices as well as the depreciation of the currency in the middle of 2006. While current account deficit in 2006 was improved to 5.7% from 6.8% in 2005, only 50 % of the deficit was covered by FDI inflows. There is little concern over the external finance as foreign exchange reserves are enough to cover nearly three times of monthly imports. Furthermore, the current account deficit is likely to narrow in 2007 as imports will fall on an economic slowdown. The country’s financial system remains sound, but the growing balance of bank loans led by those denominated in foreign currencies is fraught with possible exchange risks.

(4) Hungary is entering a crucial stage of a full implementation of the fiscal deficit reduction package

As an economic slowdown and rising inflation deepen in 2007, Hungary is entering a crucial stage of a full implementation of its fiscal deficit reduction package. The economic growth is likely to continue decelerating to around 2% in 2007 and 2008, nearly half the country’s potential economic growth rate estimated at around 4%, as additional tax hikes and full-fledged expenditure reforms are put into force. Inflation rate will rise further at least until the temporary factors wear out this summer. For the whole of 2007, the inflation rate may go above 7% from 3.9% in 2006. A murky political situation has somewhat improved as the protest rallies against Prime Minister Ferenc Gyurcsany have calmed down. However, the main opposition Fidesz-Hungarian Civic Union is strongly opposed to the deficit reduction package and proclaims populist policies. Moreover, the approval rating of Prime Minister Gyurcsany remains weak.

Main Economic Indicators: The Republic of Hungary

		2002	2003	2004	2005	2006	2007(f)	2008(f)
(Convergence criteria)	**Criteria**							
1.CPI (annual average)	2.8%(note)	5.3	4.7	6.8	3.6	4.0	7.2	5.0
2.10 year government bond yield	5.3%(note)	7.1	7.0	8.1	6.6	7.1	6.8	6.5
3.General gov’t fiscal balance/GDP(ESA95)	Below -3%	-8.2	-7.2	-6.5	-7.8	-9.2	-6.5	-5.5
4.General gov’t debt/GDP(ESA95)	Below 60%	54.0	58.0	59.4	61.7	66.0	67.3	68.5
Real GDP growth rate	(%)	3.8	3.4	4.9	4.2	3.9	2.5	3.0
Unemployment rate (year-end)	(%)	5.9	5.9	6.1	7.2	7.5	7.8	8.0
Current account balance	(EUR mln)	-4,929	-5,933	-6,916	-6,002	-5,082	-3,371	-3,186
Current account balance/ GDP	(%)	-7.1	-8.1	-8.5	-6.8	-5.7	-3.3	-2.9
Trade balance/ GDP	(%)	-3.2	-3.9	-3.0	-1.6	-0.5	1.3	1.9
Net Foreign Direct Investment/ GDP	(%)	4.1	0.6	3.4	4.7	2.7	2.2	1.6
Forex reserves (excl. gold)	(EUR mln)	9,279	9,527	11,224	15,451	15,841	15,500	14,500
Forex reserves / monthly Imports (G&S)	(months)	2.4	2.3	2.4	3.0	2.8	2.5	2.1
Forex reserves/ short-tem external debt	(times)	2.0	1.4	1.5	1.6	1.5	1.2	1.1
External debt/ GDP	(%)	56.7	65.3	70.3	76.9	94.0	91.1	88.8
External debt/ exports (G&S)	(%)	88.5	104.4	106.6	113.0	121.4	120.0	116.5
Public external debt/ exports (G&S)	(%)	40.6	42.7	43.7	43.8	43.7	42.3	40.5
Debt service ratio	(%)	13.7	14.2	15.3	15.8	15.9	17.2	18.2

(Note) Figures for criteria 1 and 2 are average between March 2006 and February 2007. Figures for 2007 and 2008 are based on JCR projection

(Source) The European commission, The National Bank of Hungary, and Ministry of Finance.

(Toshihiko Naito, Senior Analyst)